

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 06-28**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

For purposes of computing net earnings for Tennessee excise tax purposes, whether [CORPORATION X] may deduct the payments that it makes to [CORPORATION Y] as expenses for the licensing of intangibles.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the Taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual Taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The Taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The Taxpayer directly involved must have acted in good faith in relying upon the ruling and a retroactive revocation of the ruling must inure to his detriment.

FACTS

ALL FACTS ARE REDACTED

QUESTION PRESENTED

For purposes of computing net earnings for Tennessee excise tax purposes, will [CORPORATION X] be permitted to deduct the payments that it makes to [CORPORATION Y] as expenses for the licensing of intangibles?

RULING

Yes.

ANALYSIS

APPLICABLE TENNESSEE LAW

Effective for tax periods beginning on or after January 1, 2004, Tenn. Code Ann. § 67-4-2006(d) makes the following provisions:

- (d) (1) Any taxpayer that pays, accrues or incurs intangible expenses as a result of a transaction with one (1) or more affiliated business entities must disclose such intangible expenses on the face of the franchise and excise tax return filed in accordance with § 67-4-2015 and complete the appropriate schedule as required by the commissioner.
- (2) Any taxpayer that deducts intangible expenses arising from a transaction with one (1) or more affiliated business entities in determining Tennessee net earnings that fails to disclose such intangible expenses will be subject to a negligence penalty as set forth in § 67-1-804(b)(2).
- (3) If a taxpayer does not meet the disclosure requirements set forth in subdivision (d)(1), the commissioner shall make the adjustments set forth in subdivision (b)(1)(L). As such, the taxpayer will have the remedies set forth in chapter 1, part 18 of this title.

Tenn. Code Ann. § 67-4-2006(b)(1)(L) referenced in Tenn. Code Ann. § 67-4-2006(d)(3) set forth above provides for an addition to a taxpayer's net earnings or losses as follows:

- (L) Any otherwise deductible intangible expense paid, accrued or incurred in connection with a transaction with one or more affiliates[.]

As used in the above cited statutes, Tenn. Code Ann. § 67-4-2004(1) defines an “affiliate” to mean a business entity:

- (i) In which the taxpayer, directly or indirectly, has more than fifty percent (50%) ownership interest;
- (ii) That, directly or indirectly, has more than fifty percent (50%) ownership interest in the taxpayer; or
- (iii) In which a person described in subdivision (1)(B) directly or indirectly has more than fifty percent (50%) ownership interest.

The terms “intangible expense,” “intangible income” and “intangible property” are defined by Tenn. Code Ann. § 67-4-2004(18), (19) and (20) as follows:

- (18) “Intangible expense” means an expense related to, or in connection with, the acquisition, use, maintenance or management, ownership, sale, exchange, license, or any other disposition of intangible property to the extent such amounts are allowed or allowable as deductions or costs in determining federal taxable income[.]
- (19) “Intangible income” means income related to, or in connection with, the acquisition, use, maintenance or management, ownership, sale, exchange, license, or any other disposition of intangible property to the extent such amounts are included or includable in determining federal taxable income[.]
- (20) “Intangible property” means patents, patent applications, trade names, trademarks, service marks, franchise rights, copyrights, licenses, research, formulas, designs, patterns, processes, formats, and similar types of intangible assets.

Tenn. Code Ann. § 67-1-804(b)(2) makes the following penalty provisions for failure to disclose a transaction as required by law:

- (2) When any person fails to disclose any transaction in the manner prescribed by this title and fails to report and pay the total amount of taxes due, if such failure is determined by the commissioner to be due to negligence, there shall be imposed a penalty in the amount of fifty percent (50%) of the underpayment.

APPLICABLE CASE LAW

Although Tennessee courts have not had opportunity to consider facts and issues similar to those presented in this Letter Ruling request, there is case law in other states that is helpful in resolving this matter. The two cases that stand

out as being most applicable to the issues presented here are *Syms Corp. v. Commissioner of Revenue*, 765 N.E.2d 758 (Mass. 2002) and *Sherwin-Williams Company v. Commissioner of Revenue*, 778 N.E.2d 504 (Mass. 2002).

An analysis of the facts and issues considered by the court in both these cases is of value in establishing a set of criteria by which to evaluate the facts presented in this Letter Ruling request. Accordingly, the following is a brief examination of the issues considered and the results reached by the court in each of these cases.

Syms Corp. v. Commissioner of Revenue

In *Syms*, the court upheld the Commissioner of Revenue's disallowance of deductions of royalty payments made by the taxpayer to its wholly owned subsidiary, SYL, for the use of trade names, trademarks and service marks (the "marks") that Syms had transferred to SYL. The Commissioner disallowed the deductions on the following grounds:

1. The transfer and leaseback of the marks was a sham transaction.
2. There was no valid business purpose justifying the royalty payments and SYL added little or no value to the marks.
3. The royalty payments were in excess of the fair value of the marks.

Syms was a corporation engaged in the retail sale of brand name clothing at prices lower than those in department stores and used a number of marks in conducting its business.

A consultant proposed the idea of setting up a trademark holding subsidiary to Syms as a way to reduce state income tax. Under the plan, Syms would transfer its marks to SYL, a wholly owned Delaware corporation. Syms would continue to use the marks as it had before the transfer and, pursuant to a license agreement, would pay SYL a large royalty. This would generate a large state income tax expense deduction for Syms. SYL would not have to pay state income tax on the royalty income because such income is exempt under Delaware law. Federal income tax would not be affected by this plan because Syms and SYL would file a consolidated federal return in which inter-company transactions are eliminated.

In reaching its decision to uphold the Commissioner's disallowance of Syms' expense deductions for royalty payments, the court noted the following points:

1. SYL's board of directors consisted of the president of Syms, Syms' Chief Financial Officer, and a partner in the accounting firm used by both Syms and SYL.
2. SYL's office consisted of an address rented from the accounting firm used by both Syms and SYL. The accounting firm provided an address renting service for approximately 200 other corporations who used Delaware subsidiary corporations to hold their intangible assets.
3. SYL's only employee was the partner in the accounting firm which rented an address to SYL and was used by both Syms and SYL. This employee was also a board member of SYL. He was employed part time by SYL and paid \$1,200 per year.
4. Royalties amounting to 4% of Syms annual sales were paid to SYL. The royalties paid increased from approximately \$2.8 million in 1986 to approximately \$12.7 million in 1991. These royalties were paid once each year and were held by SYL for a few weeks and then paid back to Syms as a dividend with interest, less expenses amounting to approximately 1/10th of 1% of the income.
5. Business operations of Syms did not change after the transfer and license-back of the marks. All work necessary to maintain goodwill and protect the value of the marks continued to be done by the same New York law firm that had previously done the work and Syms continued to pay all expenses thereto. All advertising using the marks was controlled and paid for by Syms or a wholly owned subsidiary formed by Syms for that purpose. The choice of products sold under the marks and quality control of such products remained the responsibility of the same persons, namely the president of Syms and Syms' staff of buyers.
6. The court found the following relevant with regard to the case law cited:
 - Usually, transactions that are invalidated by the sham transaction doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit, and are structured to completely avoid economic risk. See *Horn v. Commissioner of Internal Revenue*, 968 F.2d 1229 at 1236 (D.C.Cir. 1992).

- If a transaction has no economic substance and no business purpose other than tax avoidance, it may be invalidated for tax purposes. See *ACM Partnership v. Commissioner of Internal Revenue*, 157 F.3d 231 at 247 (3rd Cir. 1998).
- A tax avoidance motive is, of course, not necessarily fatal. A corporation created, or a transaction engaged in for the purpose of reducing taxes may not be disregarded so long as it has some economic substance or valid business purpose. See *Moline Props., Inc. v. Commissioner of Internal Revenue*, 63 S.Ct. 112, at 87 (1943).
- A taxpayer must show both that a transaction was supported by a business purpose other than tax avoidance and that it had economic substance other than creation of a tax benefit. See *Casebeer v. Commissioner of Internal Revenue*, 909 F.2d 1360 at 1365 (9th Cir. 1990).
- Deductions are not permitted if the expense was created solely for the purpose of effectuating a camouflaged assignment of income. See *United States v. Estate Preservation Servs.*, 202 F.3d 1093, 1101 (9th Cir. 2000).

The court found that Syms' transfer and license back transaction had no practical economic effect other than the creation of tax benefits and that tax avoidance was the clear motivating factor and its only business purpose.

Among the business purposes proffered by Syms and rejected by the court were the following:

1. The assertion that the transfer would protect the marks from claims of Syms' creditors was rejected because creditors could reach the assets of SYL, Syms' wholly owned subsidiary.
2. The claim that the transfer would protect the marks from a hostile takeover was rejected because Syms could only have achieved that goal by transferring the marks to an independent third party, and with 80% of the stock controlled by the company founder, such a takeover was only hypothetical.
3. The assertion that the transfer would enhance Syms' ability to borrow money was rejected because creditors would have viewed the two entities as intermingled and would not have offered different financing arrangements because of the transfer. Besides, Syms never borrowed any money.

The Commissioner's position that the royalty payments were not ordinary and necessary business expenses was upheld and it was noted that:

1. The value of the marks was created entirely by Syms and SYL added little or no value to the marks.
2. Even after the transfer, Syms continued to pay the expenses associated with owning them, thus the royalty payments were unnecessary and, in effect, Syms was paying twice for use of the marks.
3. The royalty payments were not for services provided by SYL, but rather were part of a contrived mechanism by which income was shifted, tax free, between Syms and SYL for the benefit of Syms. Thus, it was irrelevant that the measure of the royalty payments might have been equivalent to what would have been paid in an arms-length transaction.
4. The fact that payment of royalties was the result of a contractual obligation does not, standing alone, render the royalties paid an ordinary business expense. See *Interstate Transit Lines v. Commissioner of Internal Revenue*, 130 F.2d 136 at 139 (8th Cir. 1942).

Sherwin-Williams Company v. Commissioner of Revenue

In *Sherwin-Williams*, the court refused to uphold the Commissioner of Revenue's disallowance of deductions of royalty payments made by the taxpayer to two wholly owned subsidiaries, Sherwin-Williams Investment Management Company, Inc. ("SWIMC") and Dupli-Color Investment Management Company, Inc. ("DIMC"), (collectively, the "Subsidiaries"), for the use of trade names, trademarks and service marks (the "marks") that Sherwin-Williams had transferred to the Subsidiaries. The court also allowed the deduction of interest payments on a loan from SWIMC. The court held that:

1. Sherwin-Williams' transfer of its marks to its Subsidiaries and subsequent royalty payments to those Subsidiaries were not sham transactions for taxation purposes.
2. Sherwin-Williams' royalty payments to its Subsidiaries were ordinary and necessary business expenses.
3. The royalty payments made by Sherwin-Williams to its Subsidiaries were reasonable.

4. The Commissioner could eliminate payments made by a parent to a subsidiary only to the extent such payments exceeded fair market value of the marks licensed.
5. The royalty payments made by Sherwin-Williams to its Subsidiaries were not in excess of the fair market value of the marks licensed from such Subsidiaries.
6. Interest payments made by Sherwin-Williams on a loan from SWIMC were necessary.

Sherwin-Williams manufactured, distributed and sold paints and related products under many brand names and, in the process, used hundreds of marks. For a number of years, Sherwin-Williams' senior management had expressed concerns about maintenance and effective management of its marks. These concerns resulted from the fact that one of its marks had been lost and decentralized management and use of many marks across divisions created uncertain authority and diffuse decision-making regarding the maintenance and exploitation of the marks. This contributed to ineffective and inadequate management of the marks as a company asset.

One of Sherwin-Williams' attorneys suggested the idea of forming two subsidiaries to hold and manage its marks and to invest and manage royalty proceeds earned therefrom. As a representative of Sherwin-Williams evaluating the potential benefits and risks of such a plan, the attorney traveled to Delaware and met with lawyers, bankers and investment managers. One of the persons consulted was a professor from the University of Delaware and owner of an investment management firm. This professor is an expert in business management, portfolio management, and corporate finance and serves as a board member of many investment companies.

Of particular concern in this evaluation process was how intangible asset subsidiaries might be created in Delaware to manage and protect Sherwin-Williams' marks, increase their value, and maximize the investment of royalty income. Discussions also took place regarding the fact that, under Delaware law, royalties and other income earned by subsidiaries formed to hold, manage and license intangibles were exempt from taxation in Delaware.

A business plan was developed for consideration by Sherwin-Williams' senior management and, ultimately by its board of directors. Sherwin-Williams' board voted to form SWIMC and DIMC under Delaware law and to transfer to them all domestic, but not international, marks. The board set forth the following reasons for such a vote:

1. Improvement of quality control oversight and increased efficiencies with regard to the marks by having profit centers separate from Sherwin-Williams.
2. Easier profit analysis of Sherwin-Williams by having profit centers for the marks that were separate.
3. Enhanced ability to enter into third-party licensing arrangements at advantageous royalty rates.
4. Increased over-all profitability because of the availability of Delaware's corporate income tax exemption for investment management and trademark holding companies.
5. Maximized investment returns associated with the marks due to separate and centralized investment management.
6. Enhanced borrowing capabilities.
7. The Subsidiaries could be used, in certain instances, to acquire businesses.
8. Ability to take advantage of the expeditious legal system in Delaware would be provided.
9. The marks would be insulated from Sherwin-Williams' liabilities.
10. Flexibility in preventing a hostile takeover would be provided.
11. Increased liquidity would be provided.

Most, but not all, of the marks were licensed back to Sherwin-Williams for 10 year terms on a nonexclusive basis. Royalty payments were to be made quarterly based on a percentage of the sale of the products bearing those marks. The value of the marks transferred and fair market value royalty rates were to be determined by an independent appraisal company.

In its decision refusing to uphold the Commissioner of Revenue's disallowance of deductions of royalty payments, the court noted the following points:

1. Original board members of each Subsidiary were the comptroller of Sherwin-Williams, who also served as chairman, the vice-president and treasurer of Sherwin-Williams, and the University of Delaware professor and consultant, who was not affiliated with Sherwin-Williams, and who also served as president and

treasurer of both Subsidiaries. A partner in the law firm engaged as corporate counsel for both Subsidiaries was elected secretary of both Subsidiaries and later was elected to both boards.

2. The board chairman of both Subsidiaries, who also served as president and treasurer of both Subsidiaries, was paid \$18,000 annually. The secretary and board member of both Subsidiaries was paid \$500 annually.
3. The Subsidiaries leased office space and space for record storage from the Bank of Delaware, where each opened their own bank accounts.
4. Each Subsidiary arranged for the Bank of Delaware to take physical custody of its marks.
5. The board chairman, president and treasurer of both Subsidiaries worked out of his own office but charged rent to each Subsidiary for the use of his office.
6. Each Subsidiary hired and paid independent corporate legal counsel and an independent auditing firm to perform audits as well as occasional quality control testing. They also hired and paid their own lawyers to represent them in multiple trademark proceedings.
7. The Articles of Organization of each Subsidiary limited its activities to maintenance and management of its intangible investments and placed restrictions and prohibitions, which were reiterated in company by-laws, on transactions in which it could engage.
8. Sherwin-Williams engaged an independent appraisal company to appraise the value of the marks being transferred to the Subsidiaries in exchange for their stock and to help establish arms-length royalty rate for the license back of the marks.
9. SWIMC and DIMC operated as ongoing businesses and entered into nonexclusive licensing agreements with Sherwin-Williams and other unrelated licensees.
10. The Subsidiaries set their own investment policies and invested their royalty income to earn a greater return than that earned by its parent on comparable funds.

11. The Subsidiaries paid Sherwin-Williams contracted market rates charged on periodic invoices for services received and observed all corporate formalities meticulously.
12. Concerns about maintenance and management of Sherwin-Williams' marks were effectively addressed by the creation of SWIMC and DIMC, the transfer/lease-back of the marks, and the described subsequent operations of the Subsidiaries.

The Commissioner offered expert testimony that the many nontax business reasons advanced by Sherwin-Williams were illusory, unrealistic, contradictory, not achievable, or could have been better achieved by internal business adjustments. However, in the opinion of the court, none of the Commissioner's experts contended that the subsidiaries were not ongoing, profit-making businesses, engaged in business activities apart from the licensing of their marks to Sherwin-Williams. The Commissioner's experts were also unable to show that the royalty rates paid by Sherwin-Williams were outside the range of royalties that would be paid by parties acting at arms-length.

In *Syms*, the court found that the transaction was specifically designed as a tax avoidance scheme. Royalties were paid once a year and quickly returned to the parent and the subsidiary did not do business other than to act as a conduit for the circular flow of royalties. The parent continued to pay all expenses of maintaining and defending the trademarks.

However, in *Sherwin-Williams*, the court found the facts to be substantially different in that there was no evidence that the transfer and lease-back of the marks was specifically devised as a tax avoidance scheme, although tax benefits were involved. Revenue, including royalties, earned by the Subsidiaries was retained and invested as a part of their ongoing operations. License agreements were entered into not only with Sherwin-Williams, but also with unrelated parties. The Subsidiaries assumed and paid the expenses of maintaining and defending their trademark assets.

Citing *Helvering v. Gregory*, 69 F.2d 809 (2nd Cir. 1934) and *Frank Lyon Co. v. United States*, 98 S.Ct 1291 (1978), the court pointed out that a business reorganization that results in tax advantages must be respected for tax purposes if the taxpayer demonstrates that the reorganization is "real" or "genuine," and not just form without substance. The taxpayer must demonstrate that the reorganization results in a "viable business entity," that is "formed for a substantial business purpose or actually engage[s] in a substantive business activity." *Northern ind. Pub. Serv. Co. v. Commissioner of Internal Revenue*, 115 F.3d 506, at 511 (7th Cir. 1997), quoting *Bass v. Commissioner of Internal Revenue*, WL 1442 (1968).

Citing a number of cases, the court stated that it agreed with courts that have concluded that whether a transaction that results in tax benefits is real, such that it ought to be respected for tax purposes, depends on whether it has had practical economic effects beyond the creation of those tax benefits. The court concluded that the *Sherwin-Williams* reorganization, including the transfer and licensing back of the marks, had economic substance because it resulted in the creation of viable business entities engaging in substantive business activities.

Although Sherwin-Williams incurred advertising expenses, such expenses were incurred to sell its products rather than to strengthen the marks, although the marks undoubtedly benefited from the advertising. Thus, Sherwin-Williams properly expensed its advertising costs against its sales. Citing *Moline Props. v. Commissioner of Internal Revenue*, 63 S.Ct. 1132 (1943), the court further concluded that tax motivation is irrelevant where a business reorganization results in the creation of a viable business entity engaged in substantive business activity rather than a “bald and mischievous fiction.”

Sherwin-Williams’ payment of royalties was found to be an ordinary and necessary business expense because Sherwin-Williams had irrevocably divested itself of all title to the marks and had the right to enjoy the property thereafter only upon payment of reasonable rental. *Stearns Magnetic Mfg. Co. v. Commissioner of Internal Revenue*, 208 F.2d 849, at 853 (7th Cir. 1954). Such payments were reasonable and at arms-length in that they followed rates recommended by independent professional appraisers.

Because the court concluded that the transfer and license back of the marks was not a sham and the royalty payments were necessary and ordinary expenses of Sherwin-Williams, and because there was no dispute that SWIMC did make a short term \$7 million loan to Sherwin-Williams at fair market value, the court held that the interest paid by Sherwin-Williams to SWIMC was properly deductible as a business expense.

EXAMINATION OF THE FACTS PRESENTED

In analyzing the points considered by the court in *Syms* and *Sherwin-Williams*, the following key factors seem to be of utmost importance in determining whether a taxpayer may deduct the payments that it makes for the licensing of intangibles as expenses in determining its net earnings:

1. The nature of the intangible property and how it is used.
2. The method by which the taxpayer transferred its patents, trademarks, franchise rights, or other intangibles to its subsidiary.

3. The existence of formal legal agreements between the parties that govern both the transfer and the use of the intangibles.
4. The method by which the value of the intangibles transferred was established.
5. Whether actual cash was exchanged in the relevant transactions.
6. Whether the company holding the intangibles has property and payroll in its state of domicile.
7. Whether corporate forms were established with regard to relevant transactions and whether the corporate requirements and formalities are being met.
8. Whether there are practical economic effects resulting from the transaction aside from tax planning.

It should be kept in mind that, in each situation, the Department will consider all related and relevant factors. In some cases, it may be necessary to consider related and relevant factors in addition to those listed above. No single factor will necessarily lead to a conclusion that is favorable or unfavorable to a taxpayer.

In applying each of the factors listed above to the facts presented, we reach the following conclusions:

1. The nature of the intangible property and how it is used.

The intangible property held by [CORPORATION Y] is described as [CORPORATION Z]® trademarks, trade names, designs, logos, domain name rights, copyrights, and nonformula trade secret rights. These IPRs are extremely valuable to [CORPORATION A] and its subsidiaries and affiliates in the conduct of their business operations throughout the United States.

The intangible assets described and their use by licensees is typical of those to which Tenn. Code Ann. § 67-4-2006(d) applies.

2. The method by which the taxpayer transferred its patents, trademarks, franchise rights, or other intangibles to its subsidiary.

As of [DATE], [CORPORATION B] owned and maintained intangibles consisting predominately of intellectual property rights related to [CORPORATION Z] and its affiliates. [CORPORATION B] consisted of two general partners, [CORPORATION C] and [CORPORATION D.] On [DATE], [CORPORATION D] assigned its partnership interest to

[CORPORATION C]. This effectively dissolved the partnership and resulted in the intangibles being transferred to [CORPORATION C]. On or about the same date, [CORPORATION C] changed its name to [CORPORATION Y] pursuant to IRC § 368(a)(1)(F).

The filing of new trademark applications including those involving work marks, logos, composite marks (words and designs together), packaging design, trade dress and other nontraditional trademarks anywhere and everywhere in the world are all handled by [CORPORATION Y], who holds all right, title and interest in such IPRs. This process is explained more fully in item #3 below.

The facts presented state that [CORPORATION Y] possesses all right, title and interest in [CORPORATION Z®] brand related IPRs. The sample License Agreement attached to the request for this Letter Ruling states that the right, title and interest in such IPRs will at all times remain in [CORPORATION Y] and that any improvements, enhancements, derivatives or innovations made by a licensee to the IPRs will be assigned to [CORPORATION Y].

Of essential importance is the fact that legal title and possession of the IPRs is not retained by [CORPORATION A] or any of its subsidiaries or affiliates other than [CORPORATION Y] and that [CORPORATION Y] retains sole possession, right, interest and legal title to such property. License Agreements document these facts and make them clear to all licensees.

3. The existence of formal legal agreements between the parties that govern both the transfer and the use of the intangibles.

As explained in #2 above, [CORPORATION Y] possesses all right, title and interest in [CORPORATION Z®] brand related IPRs and any improvements, enhancements, derivatives or innovations made by a licensee to the IPRs are assigned to [CORPORATION Y].

Documentation supporting the original transfer of intangibles to [CORPORATION Y] includes a Capital Contribution Agreement, a Plan of Merger, and Board of Director consents and resolutions.

The value of the IPRs and the establishment of charges to be made by [CORPORATION Y] for their use are documented by various transfer pricing studies performed by Deloitte Tax LLP using the comparable profits (“CPM”) method. A copy of the most recent such study is for the year ended [DATE] and was provided with this Letter Ruling request.

Loans made by [CORPORATION Y] to [CORPORATION Z] are documented by a Master Promissory Note – Revolving Credit dated [DATE] covering principal amounts advanced from time to time by [CORPORATION C] (now [CORPORATION Y]). The Note covers the applicable terms under which the loans are made, including interest rates and maturity provisions. A copy of the text of the Master Promissory Note – Revolving Credit dated [DATE] was attached to the supplemental facts provided pursuant to this Letter Ruling request.

[CORPORATION Y] licenses its IPRs to the [CORPORATION X] as well as to unrelated third parties. These transactions are documented by legal License Agreements, Design Agreements and other appropriate license contracts between the parties. These license contracts contain the specific terms under which the license is granted and details of the transaction, such as limitations on the use of the IPRs by the licensee, the license fees to be paid and default provisions.

The legal agreements and other documentation described are typical in transactions of this nature and are sufficient to legally establish the transactions between the parties.

4. The method by which the value of the intangibles transferred was established.

As previously noted, the value of the IPRs and the charges made by [CORPORATION Y] for the use of such IPRs are determined by various transfer-pricing studies performed by Deloitte Tax LLP. The most recent such study is for the year ended [DATE].

Deloitte Tax LLP applied the CPM to determine a range of royalty rates appropriate for the licensing of intellectual property. This study was performed in accordance with IRC § 482 and regulations relevant to the application of such method. The CPM evaluates whether the amount charged in a controlled transaction is at arm's length by comparing the profitability of the tested party to that of comparable companies.

The methods described in the facts and used to determine the value of the intangibles and the applicable royalty rates are appropriate.

5. Whether actual cash was exchanged in the relevant transactions.

The method by which IPRs were transferred to [CORPORATION Y] is described in item #2 above and involved a series of transactions supported by such documents as a Capital Contribution Agreement, a

Plan of Merger, and Board of Director consents and resolutions. Because of the nature of this transaction, it was not necessary that actual cash be exchanged.

[CORPORATION Y's] most significant IPR licensee is [CORPORATION X], but [CORPORATION Y] also licenses its IPRs to unrelated third parties. A copy of a License Agreement between [CORPORATION Y] and a related party is attached to the request for this Letter Ruling and is represented to be similar in general terms to licensing agreements entered into with all parties, both related and unrelated.

The License Agreement requires the licensee to calculate and pay [CORPORATION Y] license fees on a quarterly basis not later than 45 days after the end of each fiscal quarter and sets forth penalties for default.

As evidenced in the facts presented and the Master Promissory Note – Revolving Credit dated [DATE] and attached to the supplemental facts provided pursuant to this Letter Ruling request, loans made to [CORPORATION Z] and certain operating affiliates of [CORPORATION Z] and voluntary payments made by [CORPORATION Z] to reduce its outstanding principal balance are made in cash.

The facts presented also state that [CORPORATION Y] pays those who do work for it and pays its own employees.

The facts presented reflect that consideration supporting the legal validity of the licensing of the intangibles, loans made, and employees and others doing work for [CORPORATION Y] did pass between [CORPORATION Y] and the parties involved.

6. Whether the company holding the intangibles has property and payroll in its state of domicile.

[CORPORATION Y's] principal offices are located at [ADDRESS – NOT IN TENNESSEE]. It owns and operates [NUMBER CORPORATION Z®] locations and has approximately [NUMBER] employees dedicated to such operations.

In addition, [CORPORATION Y] possesses all right, title and interest in brand related intellectual property assets. These assets consist of trademarks, trade names, designs, logos, domain name rights, copyrights and non-formula trade secret rights relating to the [CORPORATION Z®] concept.

[CORPORATION Y] has its own directors, officers and employees who perform all of the various activities associated with the management and protection of its intellectual assets and the operation of its [BUSINESS] in [STATE – NOT TENNESSEE]. In the case of employees that split their time between [CORPORATION Y] and [CORPORATION Z, CORPORATION Y] pays the portion of their salary representative of the time that they spend working for it.

With respect to the management of its IPRs, [CORPORATION Y] has 1 employee located in its [STATE – NOT TENNESSEE] office. This employee is an attorney licensed in [STATE – NOT TENNESSEE] and Tennessee and performs the responsibilities of Trademark Counselor.

The facts presented establish that [CORPORATION Y] has property and a legitimate operating place of business with a paid employee in its domicile at [CITY, STATE – NOT TENNESSEE].

7. Whether corporate forms were established with regard to relevant transactions and whether the corporate requirements and formalities are being met.

The facts presented establish that [CORPORATION Y] meticulously observes all corporate formalities.

[CORPORATION Y] operates separately and independently from [CORPORATION A] and its other operating affiliates. The facts state that the relationship that exists among [CORPORATION Y, CORPORATION X, CORPORATION A] and its other affiliates is conducted on an arms length basis.

Transactions by which [CORPORATION Y] came to own all right, title and interest in the IRPs is documented by a Capital Contribution Agreement, a Plan of Merger and Board of Director consents and resolutions. License Agreements and Design Agreements support the licensing of rights to use the IPRs. The value of the IPRs and the appropriate license fees are determined by transfer-pricing studies performed by Deloitte Tax LLP. License fees are paid to [CORPORATION Y] on a quarterly basis, or in accordance with terms of the applicable License Agreements. Loans made to operating affiliates of [CORPORATION A] are evidenced by notes containing provisions for interest rates, payments and maturities.

[CORPORATION Y] has its own officers, board of directors and employees who are paid by [CORPORATION Y] for the work that they

do for it. [CORPORATION Y] retains the services of outside legal counsel to assist it in connection with its efforts to exploit its IPRs.

8. Whether there are practical economic effects resulting from the transaction aside from tax planning.

It is abundantly clear from the facts presented that practical economic effects, besides tax benefits, resulted from the transactions described.

In order to focus on development and protection of the IPRs, [CORPORATION A] choose to house such property in a separate legal entity with its own Trademark Counselor to manage and protect them. This enables [CORPORATION A] to hold [CORPORATION Y] accountable for its performance with regard to development and protection of the IPRs. In addition, [CORPORATION A] wanted to segregate its IPRs from the liabilities associated with the actual production, marketing and sales of [CORPORATION A] and its affiliates' products.

[CORPORATION Y's] activities ensure management and protection of the tradenames and trademark rights of the [CORPORATION Z®] concept. Top-level focus on intellectual property management and protection issues is increased and, as a result, the management and control of these highly valued IPRs is improved. An additional level of liability protection for the IPRs is provided.

The facts presented list and explain the following specific activities performed by [CORPORATION Y], all of which have practical economic effects aside from generating tax benefits and all of which contribute to better management and the addition of value to the intellectual property:

1. The filing of new applications for trademarks, word marks, logos, composite marks, packaging design, trade dress and other nontraditional trademarks anywhere and everywhere in the world where they will be used.
2. Prosecution of pending applications for trademarks and other IPRs.
3. General counseling, which involves such things as clearing rights to use certain IPRs, negotiating license agreements, obtaining general intellectual property advice on copyright issues, right of publicity issues, invasion of privacy issues and transactions.
4. Maintenance of IPR registrations on a state-by-state basis.

5. Enforcement of IPR rights. This involves protecting the IPRs from infringement, policing misuse of the IPRs, opposition to registrations that may infringe on the IPRs, fighting counterfeiting of products, and protection the rights and integrity of brands by aggressively pursuing other parties that intermingle counterfeits and unauthorized products into markets and engage in tax and duty evasion.
6. The licensing of IPRs to [CORPORATION X] and other affiliates and subsidiaries of [CORPORATION A] as well as to unrelated parties.

The fact that [CORPORATION Y] also owns and operates [THE SAME TYPE OF BUSINESSES] and the fact that some of [CORPORATION Y's] officers, board members and employees also do work for [CORPORATION Z] is not fatal to [CORPORATION X's] deduction of payments that it makes to [CORPORATION Y] as expenses for the licensing of intangibles as long as the relationship that exists among [CORPORATION Y], [CORPORATION X] and [CORPORATION A] and its other affiliates is kept separate and is conducted at arms length. The facts presented show that [CORPORATION Y] is a viable entity in its own right and that its operations and activities are independent from [CORPORATION A] and its subsidiaries and affiliates.

For the same reasons, the fact that the law firm of [NAME OF LAW FIRM] does work for [CORPORATION Y] and also does work for [CORPORATION Z] and its affiliates is not fatal to [CORPORATION X's] deduction of license fees paid to [CORPORATION Y]. This is especially true since the [NAME OF LAW FIRM] is the only law firm providing services with respect to the IPRs owned by [CORPORATION Y] and it does not do any work for any other [CORPORATION A] entity, subsidiary or affiliate.

Although Deloitte Tax LLP also does tax related work for [CORPORATION Y, CORPORATION A] and other [CORPORATION A] affiliates, it does not appear that this interferes with the separate and independent operations of [CORPORATION Y] or that it results in decisions being made that are adverse to, or not in the best interest of, [CORPORATION Y] and the IPRs that it owns and manages.

CONCLUSION

Taken as a whole, the facts presented clearly establish that the [CORPORATION X] meets the guidelines established by the court in *Syms* and *Sherwin-Williams* to be permitted to deduct the payments that it makes to [CORPORATION Y] as expenses for the licensing of intangibles. The transactions described are not sham transactions. They serve a valid business purpose aside from generating tax benefits and add value to the IPRs owned by [CORPORATION Y]. This

justifies the payment of royalties for the use of the IPRs. The value of the IPRs was determined by third party transfer pricing experts engaged in accordance with U.S. Treasury Regulations under IRC § 482. There is no doubt that the royalty payments made by [CORPORATION X] qualify as reasonable ordinary and necessary business expenses.

When filing its franchise, excise tax returns with the Department of Revenue on which royalty payments are deducted, [CORPORATION X] will need to comply with the following:

1. Complete the Department's informational schedule with each return on which the expenses are deducted.
2. Attach a copy of this Letter Ruling.
3. Affirm that the facts and circumstances presented in this Letter Ruling have not substantially changed since the time the Ruling was requested.

Arnold B. Clapp
Special Counsel to the Commissioner

APPROVED: Loren L. Chumley, Commissioner

DATE: 7-20-06